MASSBUDGET *BRIEF*

APRIL 24, 2008

House Action on Loophole Closing Legislation

On April 10th the Massachusetts House of Representatives approved legislation that includes both reforms that are likely to reduce corporate tax avoidance and tax rate cuts for corporations and financial institutions. This *MassBudget Brief* explains the legislation approved by the House, with special attention to amendments adopted during the budget debate. A previous *MassBudget Brief* (http://www.massbudget.org/TaxReformProposals.pdf) describes a version of this legislation proposed by the Governor in January and compares it with what was known at the time about the version of the legislation proposed by the Speaker.

During debate, the House adopted a number of amendments: the rate cut for corporations was reduced; a new rate cut for financial institutions was added; money from the tobacco tax was earmarked for Health Reform; and an amendment was adopted re-writing the section on Combined Reporting in a way that creates a series of new, and expensive, loopholes and other tax avoidance opportunities. Each of these amendments is explained below, after a brief description of the major provisions of the bill.

The Legislation Requires Combined Reporting and Conformity with Federal Entity Classification Rules ("Check-the-Box")

These are two reforms that should significantly reduce corporate tax avoidance and are projected to save the Commonwealth approximately $500 million a year at current tax rates, if implemented effectively. Combined reporting would change the way Massachusetts taxes multi-state companies. Currently, if a company operates through a large number of separate subsidiaries and other affiliates, Massachusetts taxes each subsidiary separately. This allows companies to shift income among subsidiaries so that it appears that the Massachusetts subsidiaries have little or no profit (and thus little or no tax due). States that use Combined Reporting treat a company with many subsidiaries as one single company and tax that overall company based on the percentage of its business that is in the state (generally measured by where its property, payroll and sales are). By apportioning the income of the whole company in this way (requiring "Combined Reporting"), rather than trying to tax each subsidiary separately, states can make tax avoidance much harder because companies can't shift income between combined subsidiaries to reduce their taxes in particular states. By adopting Combined Reporting, the Commonwealth would save $247 million a year (assuming the 7.5 percent tax rate the legislation phases in, but not assuming the enactment of the House amendment described later in this brief that creates new loopholes and tax avoidance opportunities).

Under existing federal laws, some companies can choose what type of legal entity they will be considered for tax purposes (as a corporation or a partnership, for example). In states with check-the-box conformity, once a company makes a choice for federal purposes, they are treated the same way for state purposes. Unlike other states, Massachusetts does not require this conformity.

15 Court Square, Suite 700, BOSTON, MA 02108
TEL: 617.426.1228 • FAX: 617.695.1295 • www.massbudget.org

As a result, companies can be treated as one type of entity in Massachusetts and as another in other states and federally. This creates openings for tax reduction strategies. By requiring conformity, this legislation should reduce those tax avoidance opportunities. This reform is expected to save the Commonwealth $107 million a year at the 7.5 percent tax rate.

Both of these reforms were recommended by the state's Special Commission on Corporate Taxation and proposed by the Governor in legislation filed in January.

The Legislation Reduces the Corporate Tax Rate by 21 percent – From 9.5 percent to 7.5 percent, Based on Economic Triggers

The version of this legislation enacted by the House would reduce the corporate tax rate to 8.75 percent in 2009 and then introduce further cuts when the economy begins to grow. Specifically, in the first year after 2009 in which baseline corporate tax revenue grows by more than 2½ percent above the rate of inflation in the fiscal year ending prior to the tax year in question, the rate would be cut to 8%. The next year that trigger is met, the rate would be cut to 8 percent. While predicting future economic trends is difficult, it seems likely that our economy will hit bottom sometime in 2008 and that growth will resume again in 2009 and 2010 allowing for rate cuts each year. This rate cut costs the Commonwealth $142 million a year when fully phased in. It also reduces the value of Combined Reporting and check-the-box conformity because the income that had previously been sheltered from the corporate income tax that will now be subject to the tax will be taxed at the new, lower, rate.

The Legislation Reduces the Financial Institutions Tax Rate by 14 percent – From 10.5 percent to 9 percent

During the floor debate on the legislation, the House adopted an amendment that would reduce the tax rate on financial institutions by half a point in 2009, and then by half a point in each of the next two years in which the economic triggers are met. This reduction, from 10.5 percent to 9 percent will cost the Commonwealth $52.5 million a year when fully phased in.

The Legislation Does Not Reduce the Tax Rate on S-Corporations

The Governor's legislation would have reduced tax rates on those S-corporations that are subject to corporate level tax in Massachusetts. These are generally closely held corporations with a limited number of stockholders. The owners of these corporations pay taxes on their income from the S-corporation under the personal income tax, but the S-corporation itself pays no tax if its gross receipts are less than $6 million. S-corporations with gross receipts between $6 million and $9 million pay a three percent tax, and those with receipts over $9 million pay four and a half percent. The Governor had proposed cutting these S-corporation taxes, which would have cost the state $49 million. The House bill does not reduce taxes on S-corporations.

The Legislation Creates New Loopholes and Tax Reduction Opportunities for Corporations

The House adopted a floor amendment that opens new loopholes, creates special rules to allow certain types of companies to reduce their taxable income in Massachusetts, provides new tax deductions, and weakens the capacity of the Department of Revenue to enforce the corporate tax laws effectively. The Department of Revenue estimates that the provisions of this amendment will "reduce the additional revenue anticipated by the Governor's combined reporting bill by at least $100 million to $200 million annually"[1]

A New Loophole for Companies with U.S. Subsidiaries That Operate Overseas

The floor amendment creates a new loophole that allows companies that have U.S. subsidiaries doing business overseas to shelter income from taxation by funneling it into those subsidiaries. The state Department of Revenue estimates that this new loophole could cost the Commonwealth more than $100 million annually.

In the combined reporting legislation filed by the Governor, any U.S.-incorporated subsidiary that was part of a unitary business was required to be part of the combined group. Including in the combined group all subsidiaries that are part of the same unitary business protects against income-shifting strategies. This amendment identifies a particular type of subsidiary that the company can exclude from its combined group: subsidiaries with 80 percent of an average of their payroll, tangible property, and sales sourced outside the U.S. This loophole can allow multinational companies to develop tax avoidance strategies that shift substantial amounts of income into these subsidiaries and reduce their state taxes accordingly. A recent *Wall Street Journal* article explained how Wal-Mart used a similar loophole in Illinois.

> Wal-Mart set its affairs so that its Italian outpost is the only operating unit of a real-estate subsidiary that controls billions of dollars of the retailer's property in Illinois and other states. Because technically its only employees are based in Italy, the real-estate unit claims its operations are foreign, exempt from Illinois corporate income taxes.
>
> Earlier this year, the Illinois Department of Revenue objected to the Italian tax maneuver, demanding $26.4 million in back taxes, interest and penalties….
>
> The dispute with Wal-Mart is part of a wider effort by some states to crack down on what they believe is abusive use of so-called 80/20 companies. These companies are domestic subsidiaries that conduct at least 80 percent of their business overseas. States typically don't tax income from outside the U.S., and many companies have used 80/20 subsidiaries to legitimately shield foreign operations from state taxation.

[1] Letter from Navjeet Bal, Massachusetts Commissioner of Revenue, to Senate President The Honorable Therese Murray, April 18, 2008. All quotations of the Department of Revenue in this MassBudget Brief are from this letter. A copy of this letter can be found at http://www.massbudget.org/LtrFrDORtoPresidentMurray.pdf.

> But authorities in several states have challenged a number of companies over the 80/20 units, claiming the structure was improperly used to shift income away from the purview of state taxing authorities.
>
> The misuse of 80/20 companies is "shocking to the conscience," said Brian Hamer, director of the Illinois Department of Revenue.
>
> *Why Wal-Mart set up shop in Italy*
> Jesse Drucker, Wall Street Journal, November 14th, 2007

A New Opportunity for Tax Avoidance for Corporate Groups that have Both Financial and Non-Financial Businesses

The House amendment also introduces special rules about how Massachusetts should determine what share of a company's income is earned in this state ("apportioned" to Massachusetts) if the company has both financial services operations and other operations. Many states, including Massachusetts, apply different rules to financial services companies than to other companies when determining how much of their income should be taxed in each state.

The House amendment would create a system in which the apportionment factors are all added together and no adjustments are made for the differences between the apportionment rules for different sectors. As a result, a company that does a large amount of business in Massachusetts could pay taxes on a very small share of its income here if a member of its corporate group is a financial institution that has large amounts of intangible assets in other states.

In describing the potential cost of this loophole, the Massachusetts Department of Revenue states, "as a majority of revenue from combined reporting would be attributable to a few dozen large corporations, potentially tens of millions of dollars could be lost if even a limited number of them dilute their Massachusetts apportionment percentages through the combination of financial and non-financial entities."

A New Tax Deduction for Companies If the Book Value of Tax Benefits Falls

The House amendment includes a provision stating, in part, that if the changes related to the adoption of combined reporting "result in an increase to a net deferred tax liability or decrease to a net deferred tax asset for any taxpayer affected by this section, taxpayer shall be entitled to a deduction." The Department of Revenue explains why this new deduction could be costly:

> The Department is concerned that deferred tax liabilities of a business may increase any time that its effective state tax rate increases. A taxpayer that has been shifting income out of Massachusetts and that will no longer be able to do so because of combined reporting will see an increase in its effective tax rate (even if the Commonwealth's stated tax rate decreases). Under the House bill, such a taxpayer could claim a new Massachusetts deduction as an offset.

While the Department of Revenue does not provide a specific estimate of the likely cost of this provision, it does state that the provision "would likely negate significant amounts of income that would otherwise be taxed under the combined reporting rules, thus significantly reducing the tax revenues that would otherwise be collected from adoption of combined reporting."

The Department of Revenue's Regulatory Authority Reduced

The amendment appears to take away from the Massachusetts Department of Revenue much of the standard authority that departments of revenue generally have to adopt regulations that implement the law. Reducing the regulatory authority of the department could strengthen the hand of companies with the capacity to design sophisticated tax avoidance strategies by weakening the capacity of the department of revenue to ensure that our tax laws are implemented in a fair, effective and efficient manner.

The Legislation Increases the Tax on Cigarettes by $1 per pack

This change is expected to generate $145 million annually. A more complete explanation of how the revenue impact of this change can be estimated is provided on page 42 of MBPC's "Tax Primer" available at http://www.massbudget.org/TaxPrimer.pdf. During floor debate, an amendment was adopted that will dedicate all of the revenue from the new tobacco tax to the Commonwealth Care Trust Fund, which funds the state's new health reform law. The amendment is drafted in a manner that would likely lead to more than the net new revenue from the increase being dedicated to the Commonwealth Care Trust Fund. Specifically, the amendment dedicates $1 per pack to the fund. The problem is that the $150 million estimate of the revenue from the new tax is arrived at by combining the new revenue from the new tax with the lost revenue from the decline in sales (and thus taxes) that the increase is expected to cause. By dedicating the gross value of the increase to this fund, without netting out the reduction, the amendment would likely dedicate significantly more than $150 million a year to this fund. This may simply be a drafting issue that will be addressed as the bill continues through the legislative process.